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the WOMAN CPA

AUTOMATION AND THE BANKING INDUSTRY

By Elise G. Jancura, CPA

ACCOUNTING FOR NONAPPROPRIATED FUNDS IN THE U. S. AIR FORCE

By Mary Jane Branick

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"People from the data processing department have also received promotions to management in other areas when their research into the operations of these areas has made them particularly knowledgable in those areas."

". . . an officer is forbidden to receive any remuneration from the Open Mess."

"He has Air Force regulations and manuals which spell out in great detail exactly how a club is to be operated, even requiring a certain profit percentage to be realized in each department."

EDITOR'S NOTES

A Signal Honor

Miss Antoinette M. Peters, CPA, President of the American Society of Women Accountants, has been invited as "one of the most prominent personalities among American women" to be a guest of the French Government for a two-week visit to France. The trip, to be made by only six women, is scheduled to include visits to industrial areas, banking associations, urban developments, universities, and hospitals, as well as some sight-seeing stops such as famous castles and the Normandy beaches.

The trip has been planned by the French Government as a means of maintaining close ties between the peoples of the two nations. Miss Peters and her five American traveling companions, the presidents of the women lawyers, women doctors, women bankers, home economists, and university women, are expected to meet with the leaders of some of France's most prominent women's organizations.

The National Association of Manufacturers suggested Miss Peters as a leader among women accountants—we bask in her glory and believe that such a selection reflects well on all women accountants and particularly on the members of the American Society of Women Accountants which she serves as President.

Miss Peters will return from France in early May and it is hoped that a future issue of this magazine will carry some remarks from her as to the highlights of her trip.

We Are Copied

"The Career Woman and The Tax Reform Act of 1969," published in the January 1971 issue, has received more comment than any other manuscript recently published in this magazine. The article by Dr. Patricia C. Elliott, CPA has evidently struck a sensitive nerve—and among more than accountants.

This Editor overheard the article being discussed by several women lawyers at a meeting of the Women's Lawyers Association of Michigan. Now, the Editor of THE NALS DOCKET, the official publication of the National Association of Legal Secretaries, has asked and has received permission to reprint the article in their bi-monthly magazine.

It is encouraging—and somewhat surprising!—to this Editor to discover the wide range of interests and occupations of our readers.

In This Issue

The two major manuscripts in this issue deal with two very different subjects—the first deals with the banking industry and how it has changed as automatic data processing equipment has become more widely used. The insights into the people problems which are created with such drastic systems changes are most enlightening.

Newspapers frequently carry stories of irregularities at PXs, officers' clubs, and various such enterprises at our service bases around the world. The second manuscript briefly discusses the accounting and business systems surrounding such activities. We believe our readers will find both articles interesting.

"Theory and Practice" this month deals with a particularly important and far-reaching Opinion which has been proposed by the Accounting Principles Board of the AICPA. This is *must* reading.

Any accountant who deals with international operations of any kind should read the "Tax Forum" this month, which deals with a recent case regarding IRC Section 482.

The reviews this month cover a wide range of topics—we think you might particularly like the review (almost a rebuttal) of a W. A. Paton article.

"The engine which drives Enterprise is not Thrift, but Profit."

John Maynard Keynes,
A Treatise on Money

AUTOMATION AND THE BANKING INDUSTRY

The author examines the effect of automation on the banking industry—with particularly interesting cases of successful and nonsuccessful conversions to automated systems.

Elise G. Jancura, CPA
Cleveland, Ohio

The Economy, Employment, and Automation

The years 1954 to 1962 saw an increase in the dollar value of the automated equipment industry of four billion dollars—a growth from three billion to seven billion dollars. The number of computers increased from only 244 installed in 1955 to 5400 in 1960 and 23,000 in 1965.[1] Unfortunately, this great surge in computer and automated equipment sales coincided with a relatively poor level of performance in the economy and a relatively high rate (5%) of unemployment. Because of the labor-saving nature of much of this equipment, this great boom in the sale of computers was labeled as the cause of the high level of unemployment and was also the basis for gloomy predictions of continual and growing unemployment. One union economist predicted, for example, that automation would destroy over 40,000 jobs per week.[2]

With such a convenient scapegoat at hand, many overlooked the basic cause of lower employment—an inadequate level of private demand. It is estimated that economic growth exceeded productivity increases and labor force growth in only six of the twelve years between 1954 and 1966 and, accordingly, during the other six years unemployment rose.[3] It wasn't until demand began to grow in the early 1960s that the employment picture improved, although the growth rate (4.9% of gross national product since 1961) was still short of the 5.2% needed to reduce unemployment to 4% by the fourth quarter of 1964.[4] The U. S. Bureau of the Census reported unemployment rates of 5.5% in 1960, 5.7% in 1963, 5.2% in 1964, and 3.8% in 1966 and 1967. By 1969 unemployment had dropped to only 3% with over 54,000 computers installed.[5]

Eventually, of course, the importance of demand was recognized. The projection of an annual rate of 2.65% increase in the standard of living leads to an estimate of an approximately \$858 billion gross national product in 1975, assuming a continued increase in productivity of 2.45% per year. The production of such an output would require the employment of about 88.7 million workers out of an anticipated work force of 91.4 million, leaving an unemployment rate of only 3%. This represents a net gain of 18 million jobs. There will be a need for 4.5 million more professional and technical workers by 1975 (an increase of 54%) and an annual increase of 1.3% in manufacturing.[6]

Automation was no longer feared but became recognized as the way to maintain the necessary growth rate so essential to high levels of gross national product, standard of living, and rate of employment. As a matter of fact, the pendulum swung in the opposite direction and by 1966, with computer installations projected at 200,000 by 1975 and 375,000 by 1980,[7] great shortages of personnel were predicted. The following statement by Mr. David B. Hertz, a director of the management consulting firm, McKinsey and Co., was fairly typical:

> In terms of immediate practical effects, neither the technical trends nor the challenge they pose to top management are the overriding issue of tomorrow—and the day after tomorrow. The overriding issue is people—specifically, skilled computer personnel. These, not the hardware, are the limiting resource. Already the supply is far short of the demand and the gap is widening inexorably. For the forseeable future there is literally no possibility that we shall have enough trained people to go around.[8]

ELISE G. JANCURA, CPA, is Assistant Dean of the James J. Nance College of Business Administration of The Cleveland State University and an Associate Professor of Accounting and Computer and Information Science at that institution.

A most capable and effective speaker on the subject of computers, Miss Jancura was formerly an Advisory Systems Engineer with International Business Machines Corporation.

Miss Jancura is a member of AICPA, Ohio Society of CPAs, AWSCPA, ASWA, Association for Computing Machinery, and American Economic Association.

Despite the optimism of Mr. Hertz's statement, the last year and a half has produced a marked increase in unemployment. Figures released at the end of 1970 show an unemployment rate close to 6%. This time there is a better recognition of the forces which affect the levels of employment and unemployment and less fear of the impact of automated techniques.

There can be no denying that the great increase in technological innovation during the past two decards have wrought, and will continue to do so, great changes in the kinds of work available. It is estimated that the average period of time between technical discovery and commercial implementation has been reduced to fourteen years as compared to the thirty-seven years prevalent prior to World War I. Whole new job categories—such as programmer and computer operator—have developed since the mid 1950s, while others—for example, elevator operator—are disappearing. While there is some disagreement as to the educational and skill requirement changes involved, there is no disagreement among the various writers about the vast amount of relocation and adjustment involved. To the individuals involved, the matter of relocating the supply of labor for the economy as a whole can represent a painful and upsetting change in the highly subjective areas of familiar routines and job satisfaction and status. What is simply a ripple to the economy as a whole can represent quite a movement to an individual industry and an earthshattering experience to an individual.

The Banking Industry

Automation has had an especially sharp impact on banking, insurance, air transportation, and communications. With its great spurt in computer usage, the banking industry provides a very interesting area for study. The use of computers by banks of various sizes over a twenty-year period is illustrated in the following table:[9]

SIZE OF DEPOSITS
(In Millions)

	Over $500	*$100 to $500*	*$50 to $99*	*$10 to $49*	*Under $10*
1955-60	27.8%	7.8%	1.0%	.0%	.0%
1960-65	92.2	85.6	52.6	11.6	1.3
1965-70	100.0	98.8	84.6	59.0	19.3
1970-75	100.0	100.0	90.5	67.8	37.9

It is expected that the number of computers actually installed in banks by 1975 will be 6,000.[10] But this figure is misleading, for there are many smaller banks which are cooperating in joint computer installations such as Bankers Data Processing, Inc., which is a joint effort installed in August 1965 to provide for the data processing needs of ten banks which own it. Other smaller banks are able to purchase services from larger banks such as that provided by the First Wisconsin National Bank to 95% of Wisconsin's banks.

There are two reasons for the great increase in computer usage in the banking industry. The first of these is to make operations efficient enough so that the banks can render the service demanded of them. In demand deposits alone, a 128.8% increase in gross national product coupled with only a 38.5% increase in demand deposits would increase transaction volume 74%.[11] The second big use is in the provision of new and expanded services—rental collections, payroll preparation for clients, retail credit servicing, and data processing services to smaller correspondent banks. It has been estimated that a bank could generate 10 to 15% in net earnings from automated customer services. The serious profit squeeze that banks have experienced in the last two years when the very tight money situation has seriously impacted banking's earnings from the more traditional credit activities make these additional sources of income attractive and necessary.[12]

The upward trend in the use of computers actually has not had the effect of reducing the total number of employees—rather it has added additional job categories while the higher volume of transactions handled by banks has raised total employment. The number of employees is expected to increase in the banking industry at an annual rate of 3.3% per year until 1975, producing an increase in number of employees of 336,000 from 1964 to 1975.[13] These projections of increased employment do not overcome the anxiety of individual employees fearing a loss of their jobs or a loss of status and/or prestige as their jobs are changed. Certain jobs will be eliminated—these are primarily those concerned with manual tasks such as check sorting and posting operations (key driven bookkeeping machines posting to statements are included in this category). At the same time there is a growing need for operators of the magnetic ink encoding machines, computer operators, programmers, systems analysts, procedural manual writers, and salesmen for the new customer services. While some of these operations require higher training levels, others, such as the encoding operation, are comparable in the skills required for the previous jobs.

Despite the fact that the goal of automation is to release man from the execution of repetitive, unthinking tasks so that he may turn his attention to more creative work, such release can only come through innovation—and innovation is often upsetting to the older, more settled employees. This is especially distressing if the new system either replaces procedures developed by the old employees or raises the fear of loss of position.

Woes of Conversion

A survey was conducted among seven medium sized banks in the Southwest which instituted electronic data processing.[14] All seven experienced personnel difficulties and fairly strong resistance to the automation process. This resistance took many forms. In some cases there was outright sullenness and increased griping. Other reactions included a running commentary on why the new system was undesirable and inefficient. Still other reactions were deliberately sloppy work, indifference, increased absenteeism and tardiness, more grievances, and strongly suspected restriction of output. This reaction occurred in first line management as well as in the clerical and accounting areas, indicating that the fear of loss of prestige and status was as important to supervisors as fear of loss of jobs seemed to be to the clerical employees.

There is a surprising difference of attitude among the people with less than two years of service and those with two or more years. The newer people, who had no vested interests and felt no particular fear of re-entering the job market which they had fairly recently left, seemed to accept the changes much more readily and calmly. Their attitude seemed to be one of little concern over the current job, with a high degree of confidence in their ability to obtain a new job.

The problems of employee resistance generated three major approaches. One was an attempt to educate employees to the new system and its effects. Unfortunately, since this action was not part of the early work, its effectiveness was limited. Some of the most troublesome persons were eliminated through the process of attrition—approximately one in ten employees left this way. The most frequently used tool in this situation was the ultimatum—this, of course, contributed somewhat to the general problems of employee dissatisfaction and resistance.

In trying to develop an approach to the most effective program of computer implementation and employee relocation, it should be remembered that the problem is primarily a human one. At the same time, it should not be forgotten that the primary objective of personnel policy is to get jobs done effectively, economically, and with as little friction as possible.

Whatever one's views on the motivation of personnel policies, it does appear that smooth transition to automated operations requires some attention to several important principles. First, personnel should be kept fully informed. In many cases, fear of the unknown is cause for greater alarm than the worst news. Second, there should be honesty regarding the areas where work will be reduced and plans should be established as early as possible for the relocation and/or retraining of the people affected. Third, to the extent that it is possible, employees should be allowed to participate in the planning. Many times "old timers" will have invaluable information which is not formally documented tucked away in their memory. As a bare minimum, employee suggestions should be courteously received and at least acknowledged. Fourth, management should make known the bank's goals and policies early in the program and specifically should indicate its plans regarding changes affecting the employees. At the least, this would assure employees that they are being considered.

The fifth principle is that management should plan ahead. The conversion period invariably brings an extra work burden; overwork is a common condition during the period of changeover. Advance planning regarding adequate facilities and help during this period can help ease the pain of the installation itself. Sixth, sufficient time should be allowed for the changes to take hold and to become familiar to the people involved before expecting high performance levels. Seventh, top management should involve itself, at least to the extent that it endorses and enforces personnel policies and promises.

A Success Story

Contrasted with the fairly difficult adjustment period experienced by the seven banks mentioned above is the success story of a bank in the Cleveland area. The relatively trouble-free growth of this bank's data processing system from a punched card system, handling essentially just its own internal records and trust fund accounting, to a large multi-computer installation handling all demand deposit and check-clearing operations and providing outside customer services such as credit card accounting, trust accounting, payroll services, and tenant accounting, is a tribute to the solid planning and honest approach to the question of change to a necessary new system. By establishing a deliberate, well-paced plan and scrupulously upholding the promise that no employee need fear for his job as a result of the changes, Cleveland Trust was able to obtain cooperative acceptance of the new techniques even if some of the older employees were nostalgic for the older ways.

The bank's development of an automated information handling system has essentially taken place in two phases. The first phase (largely in operation by 1967) was primarily concerned with the conversion of manual and punched card operations to computerized operations. The second phase, still under development, is one which involves a program of re-evaluation and improvement of the computerized techniques as well as a continuing increase in the number of activities included in the bank's automated information system.[15]

The greatest change in the first phase came in the handling of demand deposits. Here there were two innovations—the first was the decision to centralize the proving and bookkeeping functions.[16] This, of course, affected the branch offices by eliminating these activities in the branches. Secondly, the methods of accomplishing these two operations were changed. The proving operation was made a part of the encoding procedure by which the amounts of checks and deposits are recorded in magnetic ink on the documents (the account number has already been preprinted in magnetic ink before sending the blank checks and deposit slips to the account holders). These encoding machines, which are key driven, have tallying and block sorting capability so that, once proved, checks can be routed to the proper banks for payment. Here the change has not been one of numbers of employees, but rather simply a shift from one type of manual key-driven operation to another.

The next step in the processing of demand deposits is the sorting of deposit tickets and checks drawn on Cleveland Trust into account number sequence. This is done automatically by means of the magnetically recorded account numbers; then the posting of these items is done by the computer. This operation had a large impact on many employees, for the sorting and posting was previously handled manually by file clerks and bookkeepers. After posting, the checks are sent back to the branches where the checks are "paid." This means that signatures are manually verified and the decision is made whether to cancel and deduct the check or not. Ultimately, as new facilities are built at the central location, it is anticipated that this operation will be centralized. Statements are printed monthly on a rotating basis by the computer.

Typically, each branch office sends in its checks and deposits for enscribing and posting and then handles its own "paying" and customer relations. The operation for the downtown office is essentially the same as those throughout the company and thus is a good illustration. Prior to automation this office had 59 employees, of which 20 were bookkeepers and 10 were file clerks. The rest were service personnel providing research activity, customer services such as duplicate statements and stop-payment service, and internal banking analyses. After automation, this office was reduced to 45 people. Replacing the 30 bookkeepers and file clerks are 16 "paying clerks." Significantly, there was no reduction in the service personnel.

As it is the bank's announced policy that no one be laid off as a result of such innovations, the reduction in work force was carried out through transfers and the normal attrition. It is estimated that, in this job area, the normal turnover in personnel is 20% per year.[17] The increased workload of parallel operation and checkout occupied the work force until attrition reduced the work force and the normal work load took shape. This procedure worked well, for the bank proceeded to automate its branches on a deliberate pre-planned schedule which allowed for adjustment of the hiring policy in a branch prior to the change. Six months prior to the changeover, the branch ceased to hire permanent employees for the operations to be affected. Thus as time goes by, the operation can accommodate the change comfortably and logically.[18]

The estimated competence level of the paying clerks is slightly lower than that of the previous bookkeepers. The job is much more routine and carries a lower classification. Furthermore, the results are not quite as good as far as the quality of work, for there is not a break-in period as previously offered by the position of file clerk, which eventually led to a bookkeeper's job. Generally speaking, the attitudes expressed by the members of the department were cooperative and indicated acceptance of the new system, although not necessarily preference for it.

Overall, some 400 bookkeeper and proof clerk positions were eliminated in the 78 branches. However, there was not one employee laid off. A policy of internal advancement has meant that candidates for the data processing department have been selected from within the bank organization and training has been provided by the bank. The programming and systems staff was increased to 40 members by 1967, and there were an additional 50 jobs in the input preparation and balancing departments. The machine room operators averaged about 15 per shift. Furthermore, growth in the following three years produced a "computer department" staff of about 205 individuals.[19]

The growth of the data processing department opened new avenues for advancement—from operations to programming to systems analyst to supervisor to computer systems officer. A computer systems officer is considered to be on the same level with an assistant treasurer, while a senior systems analyst is on a par with a department manager. People from the data processing department have also received promotions to management in other areas when their research into the operations of these areas has made them particularly knowledgeable in those areas.

As the computer operation has matured, it too has been faced with the need for change and readjustment. There is an increasing emphasis on cost justification and treatment of computer facilities as an economic resource. Techniques are sought to make it possible to handle greatly increased volumes and to do it more efficiently. This involves even more careful planning and cost analysis and a willingness to accept and implement change in the form of new techniques and equipment. Thus the availability of faster computers means that three S/360's can be replaced by two S/370's; less expensive yet faster tape drives reduce the number of these devices required previously. Changes such as these will ultimately reduce the need for machine room staff from 45 to about 30. Overall the reduction in the total data processing staff over the next year is expected to affect about 20 of the current staff of 205.

Again, the bank's policy is to make transitions as painlessly as possible. Changes are planned in advance; thus the reduction can be accomplished with the policy of "no layoffs" by phasing conversion plans so that the rate of job elimination matches the rate of normal attrition. This means that employees who leave the department are not replaced. "Normal" attrition includes those employees who retire from the business world, who leave to accept positions with other firms, and who transfer to other departments of the bank either through promotion or lateral movement.

The transition to automated techniques and the continued developments in this area have proceeded logically and with minimum dislocation at Cleveland Trust. This has been due largely to a carefully developed plan which tried to anticipate areas of difficulty and provide solutions ahead of time. At the same time, the whole project has been placed on a realistic base which recognizes that the object is not to reduce the payroll and eliminate other costs so much as it is to provide an adequate operating base to handle the increasing processing load without undue expense. Not only has the bank been able to handle larger numbers of accounts with increasing volumes of transactions, but it has moved into such additional service areas as payroll processing for clients, accounting services for correspondent banks, tenant accounting, and credit card services.

FOOTNOTES

[1] Elias M. Awad, **Automated Data Processing** 2nd Edition, (Prentice-Hall, Inc., 1970), p. 36.

[2] **"Machines Won't Take Over After All,"** *Business Week*, October 8, 1966, p. 93.

[3] National Commission on Technology, Automation, and Economic Progress, **Technology and the American Economy** (U. S. Government Printing Office, 1966), p. 13.

[4] Charles E. Silberman, **The Myths of Automation** (Harper and Row, Inc., 1966), p. 43.

[5] Awad, op. cit., p. 36.

[6] Bureau of Labor Statistics, **America's Industrial and Occupational Manpower Requirements, 1964-1975** (U. S. Department of Labor, 1966), p. 9.

[7] Awad, op. cit., p. 36.

[8] **"The Problem Is People,"** *Banking*, April 1966, p. 111.

[9] **"The New Challenges in Bank Automation,"** *Burroughs Clearing House,* July 1966, p. 31.

[10] Constantine Konstans, **"Automation and Commercial Banking: A Perspective for CPAs,"** *The Ohio CPA,* Spring 1967, p. 58.

[11] American Bankers Association, **The Commercial Banking Industry** (Prentice-Hall, Inc., 1962), p. 9.

[12] David C. Casey, **"Bank Management: Problems and Possibilities,"** *Business Horizons,* June 1970, p. 45-52.

[13] **America's Industrial and Occupational Manpower Requirements, 1964-1975,** p. 16.

[14] Donald H. Sanders, **"Personnel Problems in Automation Changeover,"** *Banking*, September 1965, p. 91-93.

[15] Interview with Jerry McElhatton, Vice President, Cleveland Trust Company, February 12, 1971.

[16] Interview with R. L. Pelleriti, Assistant Vice President, Cleveland Trust Company, May 15, 1967.

[17] Interview with K. C. Sainberry, Assistant Treasurer, Cleveland Trust Company, May 15, 1967.

[18] Interview with J. Ross Rothermel, Vice President, Cleveland Trust Company, May 18, 1967.

[19] McElhatton.

ACCOUNTING FOR NONAPPROPRIATED FUNDS IN THE U. S. AIR FORCE

A concise description of finances involved in servicemen's clubs. This article should make good background reading for all who read frequent stories in the daily press of suspect happenings in such activities at U. S. bases around the world.

Mary Jane Branick
Everett, Washington

As the general public is only too aware when it notes the size of income tax withholdings from the weekly or semi-monthly pay check, Congress appropriates funds to support the armed services of the United States. There is a large and important area, however, for which only an insignificant amount of funds is appropriated, and funds to carry out these programs must come from other sources. This area encompasses religious, morale, welfare, and recreational activities and includes officers' clubs, service clubs, movie theaters, bowling lanes, hobby shops, nurseries, church services and programs, libraries, and whatever other facilities of recreational or morale-building nature a base is large enough to sustain. Financing for these activities, which are called nonappropriated funds or NAFs, is provided and administered by the activities themselves.

An officers' club can be used as a good example of the business aspects of such a seemingly insignificant area. Normally the Officers' Club—officially the Officers' Open Mess—will offer the facilities of a first class restaurant: dining room, ballroom, cocktail lounge, and professional entertainment. Many provide bingo and card games as well, and overseas open messes also have slot machines. Most operate a package store where bottled liquor is sold for off premises consumption; some rent rooms to transient or visiting personnel.

From the foregoing, it can be seen that the club manager has a challenging and responsible job. The club manager is an officer who has been assigned to the Open Mess as his primary military duty. Usually, he has chosen club or hotel management as his career field and has been trained by the U. S. Air Force for this profession. He has Air Force regulations and manuals which spell out in great detail exactly how a club is to be operated, even requiring a certain profit percentage to be realized in each department. The manager, officially the Open Mess Secretary, must spend many more hours on the job and on call than the normal forty hour week. In spite of this, an officer is forbidden to receive any remuneration from the Open Mess; the sergeant who manages an NCO (noncommissioned officer's) Open Mess may, however, (and usually does) get $200-$300 a month salary in addition to his military pay.

The income of the Open Mess is derived from membership dues and sales and must cover capital expenditures as well as operating costs, since each Open Mess provides its own building, furniture, and equipment. It is possible to acquire furniture and equipment at no cost from a base where an Open Mess is being dissolved. If an Open Mess wishes to build or remodel, it can obtain a non-interest bearing loan from the Central Mess Fund, to which each Open Mess contributes 1.5% of its monthly gross income. On a base where the officer complement is 90 to 100, this monthly income may amount to $20,000-$30,000.

The Open Mess follows prescribed methods of keeping records which include cash register tapes, sales slips, requisitions, time cards, purchase invoices, perpetual inventories, accounts receivable subsidiary ledgers, daily inventories, sales analyses, and profit percentage reports. These are submitted daily to another NAF, which does the accounting.

Mary Jane Branick is Treasurer of R. S. T. Corporation, Inc. in Everett, Washington.

Mrs. Branick, a graduate of U.C.L.A., began her career as a teacher in one-room schools in Arizona. **A later teaching position at a private school had an extra curricular job—keeping the books for the school. That "extra" assignment turned her interests to business college and to accounting. Her accounting positions have been varied; starting as a billing clerk, she has worked, among other places, for General Motors and as Chief of an Air Force Central Accounting Office.**

The daughter of a newspaperman and the mother of eight, she has lived "all over the United States"—including two years in Honolulu at the beginning of World War II. Now a Director of the Everett Chapter of ASWA, she plans to get another degree—in accounting—and to become a CPA.

The Central Accounting Office performs accounting and advisory functions for all NAFs on the Air Force base and sometimes for remote sites and bases too small to have their own Central Accounting Office. The CAO keeps all journals, a general ledger, fixed asset records, and prepares monthly financial statements. It prepares payrolls and writes all checks from data submitted by the Open Mess.

The chief of the CAO is a civil service employee, usually a GS11 in accounting, who supervises the NAF staff. He also acts as liason officer between the NAFs and the Base Commander. He advises the Open Mess Secretary on interpretation of regulations and manuals and ascertains that the Open Mess operation is in compliance with them. Twice a year, the chief of the CAO must make a personal inspection of Open Mess operations and procedures. He holds a conference with the Open Mess Secretary, the president of the Open Mess board, and the base Finance Office, where he discusses findings with them. He then makes a written report of the inspection and the conference to the Base Commander. He attends all board meetings to explain the financial statements and to answer questions.

The Base Auditor's office performs an audit at the request of the Open Mess Secretary, the chief of the CAO, the Finance Officer, the Base Commander, or a higher echelon authority. The Base Auditor is not responsible to the Base Commander, as is the CAO and the Open Mess; therefore, he can be absolutely frank and impartial in his report, which goes to the Secretary of the Air Force, with copies to all others concerned. The effects of this policy of independent audits are obvious—if a Base Commander insists that something be done which is contrary to regulations or if irregular activities are suspected, the Open Mess Secretary and the CAO chief may advise the Base Commander that such actions are unwise or illegal; however, because he has the final responsibility for running the base, his decision as Base Commander must be obeyed. These persons may, if they feel that an audit is desirable, request an audit which well may serve to stop such an action from being repeated.

Lastly, there is the GAO, or General Accounting Office, which is responsible only to Congress. The audits of this agency are necessarily few and far between, but greatly respected.

Nonappropriated funds, then, are administered by qualified managers, who are supervised and audited by the CAO, which is in turn audited by the Base Auditor. Finally, any discrepancies not noted by these officers will eventually find their way into the report of the GAO **(and perhaps into civilian daily newspapers!—Editor's Note).**

On the whole, business has done an outstandingly efficient job of carrying out its duties and an inconceivably bad job of explaining its function to other sectors. It is criticized severely in all quarters for callous disregard of the interests of society, for profiteering, for polluting, for exploitation, and for countless other sins against society. And yet our historically high living standards, plus the degree to which other sectors are free to concentrate attention on the quality of life, are due entirely to the magnificently effective way in which business as a whole has performed for society.

Frank S. Capon,
"The Place of Business in Society"
Financial Executive, October 1970

THEORY AND PRACTICE

Current Studies and Concepts

EILEEN T. CORCORAN, CPA, Special Editor
Arthur Young & Company
Chicago, Illinois

A synopsis of the exposure draft "Proposed APB Opinion: Accounting Changes" is presented below.

This Opinion defines various types of accounting changes and establishes guides for determining the manner of reporting each type. It also covers the reporting of a correction of an error in previously issued financial statements. It applies to financial statements which purport to present financial position and results of operations in conformity with generally accepted accounting principles.

The term accounting change means a change in (a) an accounting principle, (b) an accounting estimate, or (c) the reporting entity. The correction of an error in previously issued financial statements is not deemed to be an accounting change.

Accounting Principle

General

The Board concludes that an entity should initially adopt those accounting principles which on the basis of the substance of the facts and circumstances then existing appear to furnish results most useful to financial statement users. It also concludes that there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type.

The Opinion states that this presumption may be overcome only if the enterprise demonstrates that an alternative accounting principle that is generally accepted will provide more useful financial information. However, it states that a method of accounting previously adopted for a type of transaction or event which is being terminated or which is a single, nonrecurring event in the past should not be changed. It states that an Opinion of the Accounting Principles Board in which a preference for or approval of an accounting principle is expressed is sufficient support for a change in accounting principle. In the absence of an APB Opinion, it states that the burden of justifying a change rests with the entity proposing the change.

The Opinion provides that the nature of and justification for a change in accounting principle and its effect on income should be disclosed in the financial statements of the period in which the change is made. *The justification for the change should explain clearly how the newly adopted accounting principle results in more useful financial information to users of financial statements.*

Reporting A Change in Accounting Principle

The Board concludes that in the period of a change in accounting principle:

a. Financial statements for prior periods included for comparative purposes should be presented as previously reported.

b. The cumulative effect of retroactive application of the new accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be included in net income of that period. The amount of the cumulative effect should be shown in the income statement between the captions "extraordinary items" and "net income". The cumulative effect, while not an extarordinary item, should be reported in a manner similar to an extraordinary item. The per share information shown should include the per share amount of the cumulative effect of the accounting change. Income before extraordinary items for the period of the change should be reported on the basis of the newly adopted accounting principle.

c. Net income and the related earnings per share amounts computed on a pro forma basis by applying the newly adopted accounting principle retroactively should be shown on the face of the income statements for prior periods presented. Such disclosures should be made for:
   1. income before extraordinary items
   2. net income
   3. earnings per share amounts for "1" and "2" (primary and fully diluted, as appropriate).

   The pro forma amounts should be shown in both current and future reports for all periods presented which were affected by the change in accounting principle. If an income statement is presented only for the current period, the pro forma amounts should be disclosed for the immediately preceding period.

When the pro forma amounts cannot be computed or reasonably estimated for individual prior periods, although the cumulative effect on retained earnings at the beginning of the period of change can be estimated, the cumulative effect should be reported in the income statement of the period of change in the manner previously described. The reason for not showing the pro forma amounts should be disclosed.

If the effect on retained earnings at the beginning of the period in which a change is made cannot be estimated, disclosure will be limited to showing the effect of the change on the results of operations of the current period and to explaining the reason for omitting accounting for the cumulative effect and disclosure of pro forma amounts for prior years, e.g. a change in inventory pricing method from FIFO to LIFO.

Other matters

The Board also concludes that adoption of an amortization method for newly acquired long-term assets different from the one used for previously recorded assets of a similar class may be considered as initial adoption of an accounting principle. When a company adopts a new method of amortization for new assets and continues to use that method for all additional new assets of the same class but elects to continue use of the previous method for existing balances of that class, the adoption does not require a retroactive adjustment.

Disclosure of adoption of a new method of amortization only for newly acquired assets should include a description of the nature of the change and its current effect on income before extraordinary items and net income, together with the related per share amounts.

It also concludes that the inclusion in net income of the cumulative effect of retroactive changes in accounting principles is not required when a company *first* issues its financial statements for any one of the following purposes: (a) obtaining additional equity capital from investors, (b) effecting a business combination, or (c) registering securities. This exemption is available only for changes made at the time a company's financial statements are first used for any of those purposes and is not available to companies whose securities currently are widely held. In these circumstances the financial statements may be retroactively restated with disclosure of the change and a brief description of its nature and the justification.

Reporting a Change in Accounting Estimate

The Board concludes that the effect of a change in accounting estimate should be recognized in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in an estimate should not be recognized by restating amounts reported in financial statements of prior periods.

It states that a change in accounting estimate, i.e. residual values or periods of benefit, which is recognized in whole or in part by a change in accounting principle, such as a change from deferral to expensing of research and development costs, should be reported as a change in an estimate. This is because the cumulative effect attributable to the change in accounting principle cannot be separated from the current or future effects of the change in estimate.

The Opinion states that the effect on income before extraordinary items, net income, and related per share amounts of the current period should be disclosed when a change in estimate is made that affects several future periods, such as a change in service lives of depreciable assets. Disclosure of the effect on those

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Now, and in the future, an executive's effectiveness can be seriously jeopardized if he does not have a conscience.

W. W. Keeler,
Chairman of the Board,
Phillips Petroleum Company.

TAX FORUM

ANNE D. SNODGRASS, CPA, Editor
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During the past year while tax practitioners have been concentrating all efforts toward keeping up with the impact of the Tax Reform Act, some significant developments have taken place in the courts. In January a Tax Court Memo Decision was reported which defines to some extent just how much discretion the Commissioner of Internal Revenue has in applying Section 482 of the Internal Revenue Code. At least the opinion sets forth what the Tax Court considers to be an abuse of that discretion. The case is *PPG Industries, Inc. v. Commissioner,* T. C. Memo 1970-354 and may be found in the CCH Tax Court Reporter at 29 TCM Dec. 30,488(M).

Section 482

Internal Revenue Code Section 482 authorizes the Commissioner of Internal Revenue to allocate income and deductions between related companies or taxpayers for the purpose of preventing the evasion of tax through the shifting of profits, the making of fictitious sales, or the use of other transactions which result in the "milking" of an entity which is subject to United States tax. Suppose, for example, that Company A has developed and is manufacturing and selling a product which has reached its full potential in the United States but is just being introduced in Europe. The company decides to organize a Swiss subsidiary to which it will sell its products at a very low price. Then Company A will realize very low profits on this segment of its business, and Swiss-A will realize very high profits which are taxed at much lower rates in Switzerland. Under Section 482, the Commissioner has the authority to allocate a part of the income from the Swiss corporation to the U. S. corporation and to impose U. S. taxes on the income so allocated. When the Commissioner applies Section 482, normally the taxpayer must prove that the reallocation is unreasonable, arbitrary, or capricious in order to avoid the deficiency assessment. The taxpayer can do this by producing evidence that the transactions with the foreign subsidiary took place at arm's length prices within the meaning of the U. S. Treasury Regulations under Section 482.

Section 1.482-1(b)(1) of the U. S. Treasury Regulations states that the "purpose of Section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer." In other words, how much income would the controlled taxpayer have earned had it dealt with the parent at arm's length? The Regulations set forth detailed criteria for determing prices which can qualify as arm's length prices where sales of tangible property are involved. There are three methods which can be used; but, where the product is one for which there is an established market, the method known as the "comparable uncontrolled price method" must be used, as it results in the more accurate estimate of an arm's length price. As the name implies, the comparable uncontrolled price method involves looking at the prices paid in comparable transactions between unrelated buyers and sellers.

The Government's Case

The example of Company A and Swiss-A above is a somewhat over-simplified statement of the transactions which were the subject of one of the main issues of the *PPG Industries* case. A wholly-owned subsidiary was organized as a Swiss corporation for the purpose of expanding the sale of PPG products outside the United States, as well as developing opportunities to exploit the company's technology outside the United States and developing opportunities for investments where equity interests could be built around the manufacture of products using PPG's technology. It was also intended that the Swiss subsidiary would manage those foreign investments already in existence at the time the Swiss company was formed. All export sales, foreign licensing, and investment activities were placed under the independent management of this subsidiary. The Commissioner assessed deficiencies measured by income allocated to PPG from the Swiss subsidiary. The income so allocated was primarily derived from sales of tangible property; therefore, the methods for determining whether or not the transactions were actually arm's length were applied. The Court found that the prices used by PPG were representative under the comparable uncontrolled price method and held for the taxpayer.

Unfortunately, when one is dealing with the wholesale merchandising of manufactured products of the type PPG Industries produces, the comparison of pricing policies is a very complex process. The Revenue Agent had relied upon the "Source Book of Statistics of Income" compiled by the United States Treasury Department for 1960 and 1961. In this publication, organizations filing Federal income tax returns are grouped into major and minor industry classifications. Within these classifications, the companies are grouped into size categories based upon the value of their assets. The Revenue Agent established the classification and category in which the PPG Swiss subsidiary properly belonged by referring to the company's balance sheets for the years involved. He then determined the ratio of net profit before tax to business receipts for the appropriate group of corporations. He applied this ratio to the PPG subsidiary's business receipts and contended that this was the appropriate profit before tax for the subsidiary. Since the Swiss company's profit before tax exceeded the amount so determined, he reallocated the excess income to the parent and based the deficiencies on this additional income.

The Court was convinced that this method of determining the allocation of income to the parent company was unreasonable and arbitrary. There was no indication from the evidence produced by the Commissioner that the operations of the corporations in the group from the "Source Book" were in any way comparable to the operations of the PPG subsidiary. The Revenue Agent testified that this was the best information available to him at the time, but, in the Court's opinion, this agent's best was not good enough. It was held to be an abuse of the Commissioner's discretion in the application of Section 482.

However, the Commissioner of Internal Revenue did not give up that easily. During the course of the trial, things must not have looked too good because the Commissioner took a new position and amended the answer to the taxpayer's petition. In the amended answer, the Commissioner contended that the PPG subsidiary's activities were comparable to those of a combination export manager of the type earning a nominal net profit margin of two percent of net sales. The Commissioner further contended that the Swiss subsidiary's sales to PPG's Canadian subsidiaries were mere "paper shuffling." The amended position allocated to PPG all of the income from the Canadian sales and all earnings from other operations in excess of two percent of net sales.

A combination export manager handles the exports of a group of manufacturers. He is an independent contractor or agent and normally handles the mechanics or paper work involved in exporting products and also performs a limited selling function by selecting foreign commission agents or distributors for the manufacturer. The combination export manager does not perform a marketing function; he has nothing to do with the development of new markets, does not decide price policies, nor can he sell at a loss in order to develop new markets.

An international subsidiary normally performs a number of functions which are never delegated to a combination export manager. These include the management responsibility for foreign operations other than selling, the coordination of foreign marketing activities, including in-depth studies of potential markets, the extension of credit to customers, the operation of warehouses, and various post-sale services to customers. The PPG Swiss subsidiary was responsible for many other manufacturing and investment management functions.

When the Commissioner changed his position from the rather casual approach produced by the Treasury Department statistics, the burden of proof shifted to him. He not only didn't prove his case, but the evidence on the side of PPG was rather overwhelmingly to the contrary. A major difference between a combination export manager and an international subsidiary is the extent to which an international subsidiary attempts to develop new markets. The PPG subsidiary had a phenomenal increase in sales during the period—a strong indication of extensive marketing activities. Even though some export management functions were performed by the PPG subsidiary, the Court found them to be minor in comparison to the main thrust of its responsibility.

The Taxpayer's Case

The significance of this opinion on this particular issue appears to rest more in the Commissioner's lack of ability to prove his case than the taxpayer's overwhelming evidence refuting the Commissioner's position. However, it is still pertinent to outline those facts which the Court especially noted were in the taxpayer's favor. The Finding of Facts portion of the opinion is some 45 pages long, so the following can scarcely be an in-depth analysis.

In the first place, PPG was able to develop a great deal of evidence supporting their pricing policies and the objectives which they intended to achieve. Price guidelines had been devised which would yield the U. S. company a profit of at least 10 percent of sales. In no event were goods sold at less than inventoriable cost plus 25 percent. Also, PPG was able to develop evidence regarding the prices used

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REVIEWS

Writings in Accounting

DR. MARIE E. DUBKE, CPA, Editor
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"Earmarks of a Profession—and the APB", W. A. Paton, *The Journal of Accountancy,* Vol. 131, No. 1, Jan. 1971.

While many (see review of the Business Week article, "Why Accountants Need to Tell a Fuller Story") feel that the APB's action is strengthening the accounting profession, Paton (well-known Dean of Accounting in Michigan if not in the entire country) feels that the APB "may impair the professional status of accountants." He is highly critical of the attitude that accountants should "serve the public" and be independent. He suggests that "his function is to provide the best public service to his specific clients, the people who pay for his efforts." He also states that in a poll of images today, "security analysts . . . would be among those fighting it out for bottom spot."

Paton apparently resents the APB's recent opinion which requires uniformity of treatment for business combinations which meet a whole gamut of specified conditions; at the same time, he states that previously, both orally and in writing, he attempted to pursuade the old Committee on Accounting Procedure to oppose the whole pooling idea. *May the reviewer point out that, if the prior committee had had sufficient intestinal fortitude to restrict pooling in the same narrow fashion as the APB has done, history of the past decade would be quite different?*

Agreed, total abolition would have been preferable; but a door open just a crack is better than a wide open door when one wants to restrict or eliminate traffic! We presently have an instrument which permits but restricts *pooling, thus preventing much of the abuse which has occurred in the past decade. This measure passed while, from reports, total abolition of this highly questionable practice would not have mustered the required ⅔rds vote on the Board. As Paton says, "the minority is often on the right track", but it is a wise minority that will compromise to make* some *forward progress when total victory is impossible.*

Paton points out that one would have difficulty giving away copies of corporate annual reports. He doubts that many people read them. *However, this reviewer would point out that the financial editors have in the past read them well enough to pick out erroneous earnings per share and "cash flow per share" figures placed in many reports by members of the management team. This reviewer holds that it is much better for the APB to prescribe minute details for the accountant to follow if, in so doing, erroneous computations are forced out of the annual reports entirely.*

The APB is not perfect and changes may be made in the future to improve present Opinions. In comparison with the previous Committee on Accounting Procedure, its efforts seem favorable. It was while the previous committee was in session that Lifo gained popularity; that cost or market, whichever is lower, procedures were advocated (does any firm actually apply this procedure?); that eight *ways of handling write-offs of real and property taxes were recognized as "generally accepted"; that amortization of discounts over the original life of a* retired *issue of bonds was promulgated; and that pooling of interests was blessed.*

Mr. Paton has every right to express his opinion. This reviewer hopes this article of his will soon be forgotten and not detract from previous writings of this accounting giant. It is hoped that the APB will continue to tackle knotty issues and compromise only when necessary; otherwise students of tomorrow may place Accounting even lower in the list of professions. Heaven forbid that we should be proved guilty of helping to bilk the public because of our overattention to serving the private interests of moneyed individuals.

M. E. D.

"Training to use the Computer as an Executive Tool", Richard T. Becker, *Personnel,* Volume 47, No. 6, Nov./Dec. 1970.

There are two main training areas in the management training function changed by the age of the computer. These are increased use of the computer by management in areas such as long-range planning, product life analysis, and manpower planning and the use of the computer in training executives in various management functions. Mr. Becker presents the approach used by B. F. Goodrich, who used background training as early as 1959.

This has evolved into its current efforts to use the computer as a tool in the training of executives.

Sessions involving the modeling techniques have proved to be enlightening to many executives. Risk analysis has taken a broad spectrum of managers from various job functions. Another program is a planning systems generator. This is another modeling technique which can be applied in any kind of activity from finance, marketing, and manufacturing to union relations. Main emphasis currently is on systems analysis tailored to the management functions.

Goodrich has been able to pinpoint some of the problems of training executives in the uses of the computer. One obstacle is a reluctance on the part of executives to admit a lack of comprehension. Another is the necessity of continual reinforcement. Also, management had to be set straight about its expectations of glorious results from a computer.

Mr. Becker concludes, "The advent of the computer as far as training personnel is concerned is a two-way street. One direction is to spread the knowledge of computer technology and the other is the use of the computer as a training tool per se."

Dr. Patricia L. Duckworth, CPA
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"Financial Disclosure Patterns in Four European Countries," Anita I. Tyra, *The International Journal of Accounting Education and Research,* Volume 5, No. 2, Spring 1970.

In this article, Dr. Tyra investigates the charge that "disclosure in annual reports of European companies is frequently thought of as inferior to financial disclosures made by U. S. corporations." Published corporate reports from West Germany, France, the Netherlands, and the United Kingdom were analyzed on the basis of 15 points covering consolidation practices, financial summaries and statistics, disclosures, and the auditor's report. The analysis was made to determine the influence, if any, of the capital market, companies law, and the accounting profession upon reporting practices.

The author presents a comprehensive but brief summary of the environmental factors within each of the four countries. This alone makes the article a worthwhile investment of time for those concerned with internationalism. The conclusion of this study should make all of us stop and think—**"legislation exerts a much greater influence on corporate financial disclosure in the four countries studied rather than either their respective capital markets or accounting professions."**

Dr. Marilynn G. Winborne, CPA
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"Why Accountants Need to Tell a Fuller Story," *Business Week,* No. 2162, Feb. 6, 1971.

Have you wondered where accounting is going? And why? The Finance Commentary of this issue reads like an appeal to the accountants to take steps toward greater professionalization. The article credits Leonard Savoie with influencing "the AICPA . . . to bring a tougher discipline into the rather disorderly ranks of the profession."

Touche Ross and Arthur Young are recognized as revolutionary firms, joining the previously-indicted "maverick", Arthur Andersen, in pushing for more strength for the APB. The article states that "the accountants will need some real backing from the Securities and Exchange Commission." It also suggests that Congress and managements will have to cooperate if progress is to be made.

Many accountants are cheering along the sidelines and wish the revolutionaries and the AICPA "God-speed" in their efforts to put the accountants' house in better order.

M.E.D.

"Mechanizing the Small Office," Edmund J. Wells, *Management Services,* Volume 7, No. 5, Sept.-Oct. 1970.

Mr. Wells describes a way of organizing the mechanization effort of a small business and the roles of the major participants in the mechanization process. Four requirements for successful mechanization are listed:

- Top management should fully understand the implications of mechanization before making a decision to mechanize. Mechanization for mechanization's sake is not a sound basis for a decision.
- The system should be simple without being simpleminded. Simplicity with completeness requires considerably more effort than complexity with completeness.
- Substantial involvement of top management and the users of the reports during design and installation is essential to the success of the system.
- Office personnel must be adequate. Mechanization will not solve problems that stem from substandard personnel.

The last two pages of the article contain a table which lists the steps in the mechanization process and the roles of top management, middle management, office staff, consultant, manufacturer, and service bureau.

Mary E. Burnet, CPA
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"The Evaluation of Liquidity: An Analytical Study," Kenneth W. Lemke, *Journal of Accounting Research*, Vol. 8, No. 1, Spring 1970

Current ratio concepts, part of the inviolable body of law of financial statement analysis, are described by the author as "almost venerated by accountants and other financial decision makers as a prime criterion of liquidity." Nevertheless, he points out with simple case studies that a changing current ratio is not an infallible sign of improvement or deterioration in the liquidity of a firm. Inadequacy of the current ratio analysis relates to its static, or "snapshot," character and to the collection of many variables which have differing effects on liquidity.

The study first presents some basic assumptions as to profit maximization, along with constancy of price levels and income tax rates that are obviously unrealistic but do provide parameters for observing the factors that affect liquidity. This proceeds through a brief examination of the major components of the current ratio and introduces a standard inventory reorder formula that is very close to the heart of the thesis, since inventory levels do not rise in equal proportions to rising sales but rather by the square-root of sales increase.

The proposal is for a liquidity flow-index which is advocated as dynamic rather than static and which can be prepared for periods short enough to avoid intraperiod cash deficiencies. Liquidity flow-index is defined as the ratio of practical maximum rate of outflow to required rate of outflow. Figures for developing the ratio may be taken from past performance or from future projections.

Ex post liquidity flow-index is derived from historic figures for a specified unit of time; in the case of a twelve-month interval, this ratio for a financially healthy firm will approximate unity. A projected liquidity flow-index will have to consider internal generation of cash and receivables by reason of profit and is consequently subject to the volatility of earnings and the optimism of the analyst. The retrospective liquidity flow-index, usually the only form available to an outside analyst, looks backward over more than one time unit. All three time concepts will lead themselves to refinements and modifications to suit a particular firm and may also permit recognition of special-purpose funds without distortion of the general liquidity flow-index.

The proposal admits to some limitations in accuracy of liquidity flow-indices by omission of the borrowing potential of the firm and because of the obsolescence and income-smoothing factors of annual report figures. Regardless of these defects, the author concludes that use of a liquidity flow-index still seems to offer significant improvement over the current ratio analysis.

Constance T. Barcelona
Camargo Club, Cincinnati

"ACCOUNTING FOR HUMAN RESOURCES," R. Lee Brummet, *The Journal of Accountancy*, Vol. 130, No. 6, December 1970.

At the joint annual meeting of ASWA and AWSCPA in Washington, D.C. in 1969, Mr. Brummet was the most popular and well-liked speaker. He spoke on accounting for human resources, a topic which has not been explored by many and which has been experimented with by only a few companies.

A similar paper, presented to the American Accounting Association in 1969, has been reprinted in "Statements in Quotes." *For those who missed Mr. Brummet's speech (or wish some review of the subject), it is now available and recommended for your reading list.*

M.E.D.

"INTERNAL CONTROLS FOR DATA PROCESSING," Troy J. Smith, *Management Review*, Vol. 59, No. 2, February 1970.

Mr. Smith begins by stating that the internal auditor must know the actual position of the data processing department in the corporate organization in order to define the internal controls to be established over its operations. Then he must establish the input controls, the program controls, and the controls over bursting, decollating, and binding. All of these controls are discussed in the article.

The author, who is with North American Aviation, Inc., concludes the article with some test questions that can reveal whether or not proper controls exist in the company. *This article should be a "must" reading for any internal auditor who faces the responsibility of defining internal controls for the data processing function.*

Dr. Patricia L. Duckworth, CPA
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THEORY AND PRACTICE

(*Continued from page 13*)

income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence; however, that disclosure is recommended if the effect of a change in the estimate is material.

Reporting a Change in the Entity

The Board concludes that accounting changes which result in financial statements that are in effect the statements of a different reporting entity should be reported by restating the financial statements of all prior periods presented.

It provides that the financial statements of the year in which a change of reporting entity is made should describe the nature of the change and the reason for it. In addition, the effect of the change on income before extraordinary items, net income, and related per share amounts of the period of change should be disclosed. Similar disclosures should be made of the differences between amounts previously reported in periods presented and those shown in the restated financial statements.

Reporting a Correction of an Error in Previously Issued Financial Statements

The Board concludes that correction of an error in the financial statements of a prior period discovered subsequent to their issuance should be reported as a prior period adjustment. It provides that the nature of the error in previously issued financial statements and the effect of its correction on income before extraordinary items, net income, and the related per share amounts should be disclosed in the period in which the error was discovered and corrected.

TAX FORUM

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with respect to sales to and purchases from unrelated parties. A Belgian subsidiary had purchased glass from another Belgian company outside the controlled group; the prices were shown to be lower than the prices PPG was charging its Swiss subsidiary. Comparisons with the prices charged to U. S. customers also indicated that PPG was not selling to its Swiss subsidiary at abnormally low prices.

The second test applied was the over-all reasonableness of the profits reported by the subsidiary. The financial statements had been completely restated as the original statements were unaudited and had not shown income from export sales separately from other income in each product line. The cost system was altered to some extent on the restatement. The court agreed with the overall reasonableness of the financial reports submitted in evidence and approved the accounting principles used in the restatement of the financial reports.

The third factor considered was the ratio of profit before tax to gross sales of the Swiss subsidiary as compared to the U. S. parent's profit before tax on the export sales. It was shown in the restated financial statements that the parent company was making a higher gross profit margin and net profit before tax on its sales to the Swiss subsidiary than the Swiss subsidiary was making on its resale of the same products.

In Conclusion

A number of other interesting Section 482 issues were raised in the *PPG Industries* case, but space does not permit a full discussion of all of them. The Commissioner of Internal Revenue has not had adequate guidelines to follow in raising Section 482 issues. This has made it difficult for industry to establish pricing policies which would be sufficiently liberal to allow them to penetrate world markets and yet not so liberal as to raise the spectre of a Section 482 reallocation of income. By the time the Internal Revenue Service has raised such an issue, it is usually too late to recover any foreign taxes paid with respect to the same income. The facts involved in the *PPG Industries* have been reported in intricate detail. Hopefully, the case establishes some guidelines for both the taxpayer and the Revenue Agent.